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Commentary on Pertinent Economic Issues

Similarities and Differences

Irwin L. Kellner
Chief Economist

Let's face it, business downturns are nothing new. Since the middle of the last century, the United States economy has experienced at least 30 periods in which aggregate economic activity declined enough to cause widespread losses of jobs and businesses. Some were mild, lasting a matter of months, while others were more severe, stretching a couple of years or more. Since these contractions all struck after a period of economic expansion, the contrast was all the more obvious. Not surprisingly, considerable shock and dismay accompanied them.

The current recession is no exception. Although it did not arrive with the suddenness depicted either by the mass media, or by the Administration, there is no denying that America's ninth postwar business downturn is now underway. And because of the many seemingly unusual events surrounding it, more than a few have opined that this recession is more likely to be severe, than mild. Indeed, the most frequently asked question nowadays seems to be what is going to get us out of this slump?

I don't want to belittle the pain and suffering that many are now experiencing, but I would like to suggest that this recession is more similar to its postwar predecessors than it is different. That being the case, the odds would seem to favor a recession that turns out to be no worse than most others we've experienced since the end of the Second World War—and containable by the right economic policy.

Manufacturers Hanover
Economics Department
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Saddam's Recession?

Those who assert that this is a different kind of recession refer to both its origins, as well as to the way it is developing. With this framework in mind, let us examine how this downturn began. The most common view in and out of Washington is that Iraq's invasion of Kuwait in August turned an economic slowdown into a full-blown recession, as oil prices shot up and confidence plunged. Since the two Mideast crises of the 1970s were also followed by recessions—and these flareups struck during economic booms—such a view is not unreasonable.

The key here, is to go back *before* August 2, when the invasion began. Most of the economy had already been declining. Indeed, as these Reports have been making clear, many industries and regions had been gasping for air for a year or more, under the pressure of a tight monetary policy administered by an inflation-wary Federal Reserve. True, one measure of monetary policy, the level of short-term interest rates, had been falling since the spring of 1989. Thus the Fed might claim that it was actually easing well before the economy stopped growing. However, such quantitative measures of Fed policy as the growth of the money supply, M2, as well as total bank reserves, tell a far different story. Indeed, with bank reserves contracting in 1989 by about the greatest percentage in the entire postwar era, and money growth sluggish, at best, it seems more likely that interest rates fell because the Fed *let* them—not because it tried to *push* them down as part of a policy of aggressive monetary ease.

The next question is why was the Fed so tight? Two reasons come to mind. One, of course, is its ongoing fear of inflation. The other, less commonly known explanation involves policy errors. Let's examine the inflation arguments, first. Back at the end of 1986, thanks to the earlier plunge in the price of oil, the U.S. enjoyed its lowest rate of inflation in over 20 years. Consumer prices wound up rising only one percent, year over year, while several other price indexes registered actual declines! But oil prices had started to climb by the middle of that year, and growth in the gross national product rebounded from the energy-induced drop in 1986's second quarter. Gold and other precious metals' prices had begun to climb, fueled by a sharp jump in industrial raw materials' prices as the goods-producing sector responded to the decline in the value of the dollar against the currencies of our major trading partners.

The net result was that both short- and long-term interest rates hit bottom in late 1986 and began to climb substantially during the first three quarters of 1987. Short rates rose faster than longs, causing the yield curve to flatten by 1988—and become negative in 1989 for the first time since the last recession. After rising in early 1987 by the largest percentage in postwar history, total bank reserves, as observed above, fell two years later—by a near record percentage.

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Tight Money Stifled Growth

This unprecedented monetary tightening, along with some inadvertent help from fiscal policy, set the stage for the slowdown in economic activity that was in progress *before* the Persian Gulf crisis began. Higher interest rates had already suffocated sales of autos and housing in early 1987, and eventually took their toll on the stock market, in the form of the maxi-crash of 1987, and the mini-crash of 1989. Fiscal policy, mainly the Tax Reform Act of 1986, contributed by distorting spending patterns at the end of 1986—not to mention by discouraging investment in real estate from 1987 forward.

What was happening to the rate of inflation throughout this period? By some measures, such as the consumer price index, it rebounded—but only to where it was in 1984. By others (the so-called "core", or underlying rate of inflation excluding the often-volatile food and energy sectors), it continued to drift lower. And while prices of industrial raw materials (which exclude food, energy and precious metals), climbed until early 1989, they're now some 12 percent lower.

However, even at the consumer level, price inflation was less than it appeared. At midyear 1990, most of the rise in goods prices had ceased; whatever inflation remained was largely in services—mainly education and medical care (Economic Report—August 1990). Thus one policy error was that the Fed continued to focus on reducing inflation long after that part of inflation which could easily be dampened by Fed policy was checked. But there were others as well. As the dollar plunged from February 1985 through summer 1986, the Fed evidently must have expected this decline to lead to a pickup in inflation, since by its measure, the dollar had fallen over 30 percent in 18 months. Such a drop in the value of the dollar could be expected to lead to inflation in two ways: (1) by making imports costlier, thus providing domestic manufacturers with an opportunity to hike their selling prices, and (2) by making exports cheaper, thus boosting demand for U.S.-made goods overseas, thereby tightening up our domestic economy.

Inflation Fears Were Exaggerated

All this might have been true—had the dollar fallen by as much as the Fed thought. But while the dollar did decline this much, it did so only against the industrial countries' currencies. Against a broader measure, which includes the currencies of the developing countries of Southeast Asia and Latin America—such as is contained in the Manufacturers Hanover Trade-Weighted Dollar, introduced in September 1986—the dollar had actually fallen by less than five percent. This would seem to be a more accurate measure of the dollar's international value than the Fed's, since the industrial countries' share of our two-way trade had been declining for most of the 1980s. The proof of this is the failure of our trade gap to drop in the face of the dollar's plunge as calculated by the Fed. In turn, this would suggest that the inflation threat from a declining dollar was not as great as it appeared.

Looking back, it's not difficult to understand the Fed's unusual concern over inflation. Alan Greenspan replaced Paul Volcker as Chairman of the Fed in the summer of 1987. Because he was a well-known Republican confidant, he probably felt that he had to overcome the markets' fear that his selection was aimed at ensuring the Republicans' election chances in 1988, so he kept money tighter than Mr. Volcker would have, in order to establish his credentials as a genuine inflation-fighter (Economic Report—July 1987).

A respected private economist and inveterate numbers-watcher, Mr. Greenspan undoubtedly was aware of the underlying weakness in the U.S. economy as he tried to guide it toward a "soft landing"; ie: slowing growth to the point where price pressures are dissipated—yet not to the point where the expansion stops altogether and a recession begins. That, in itself, was risky, but when combined with a fiscal policy whose budget deficit was widening—thus working against the objectives of monetary policy—instead of shrinking, it became a practical impossibility, exposing the U.S. economy to an external shock, such as the Mideast crisis. Indeed, concern over the potential inflationary effects of the widening budget deficit also kept the Fed from easing as much as the economy needed.

Complicating the Fed's strategy was the rise of the so-called money market economists. These analysts tend to focus mainly on the daily course of events, rarely stepping back to see the forest for the trees. Ever since the Fed announced money supply growth targets back in the mid-1970s, these people have been looking over the central bank's shoulder to make sure it

was not capitulating to the forces of inflation. As recently as ten months ago (Economic Report—April 1990), these market economists were exhorting the Fed to *tighten* money on the basis of what was then a rapid rise in employment. This was a completely misleading way to look at the labor situation, as I pointed out then, but, unfortunately, the Fed had been taking its cues from the markets, instead of the other way around, so it was reluctant to ease more aggressively.

Policy Miscalculations

If these factors weren't enough, add two more. The first deals with the way the Fed implements monetary policy. As observed in the August 1989 Economic Report, prior to 1983, the Fed focused on nonborrowed reserves in the banking system as its main control instrument. Its aim was to achieve a rate of money supply growth consistent with its usual objective of sustainable economic growth and price stability. But financial innovation and deregulation weakened the link between money and the economy, so the Fed shifted to a borrowed reserves-based operating procedure.

The Fed reasoned that, rather than go back to pure interest rate targeting, it would attempt to gauge market pressures by the degree to which member banks would borrow from its discount window in response to a widening or a narrowing of the gap between the discount rate and the Federal funds rate. Bank borrowings used to correlate with the change in this gap, but from early 1988 on they failed to do so. This was not a sign that the Fed wasn't tight enough—as the Fed thought was the case—but rather, it reflected several developments, among them the switch in 1984 to biweekly reserve maintenance periods, fears of recession inducing the banks to curtail lending and the need to improve capital ratios, leading to the same result. Thus the Fed wound up being tighter than it had intended—witness the drop in total bank reserves referred to earlier.

The other factor involves the Fed's role as a regulator of the banking system. As noted above, the commercial banks have been under pressure to improve their capital ratios. There are, of course, a number of ways to accomplish this, but in today's economic and investment environment, the approach most often used is to cut back on new lending. This is one of the reasons cited for today's so-called "credit crunch".

Thus, from here, at any rate, it would appear that this recession's origins were, in the final analysis not all that different from those past. It was for the most part brought on by a restrictive monetary policy, reacting to, among other factors, what seemed to be signs of rising inflation. Those who say that the economy was not expanding too rapidly just prior to the downturn ignore the fact that it was—several years earlier. The prolonged period of monetary tightening, plus the two stock market crashes, help explain why such usual "pre-recession" signs as a buildup of inventories, rapid economic growth, high capacity use, and a surge in prices, wages and jobs, were largely absent a month or two before the slowdown turned into an actual recession.

As for the way it is developing, it has both ordinary as well as unusual characteristics. On the ordinary side, attitudes have soured, leading people to postpone purchasing big-ticket items, vacations, eating out, etc. Businessmen have reacted by tightening their corporate belts, slashing payrolls, advertising and other promotional expenses, while delaying any plans to modernize or expand. As these developments have cut into tax revenues, state and local governments have been forced to raise taxes and/or lay off workers—further depressing their economies.

Unusual Developments

On the unusual side, because this recession was so long in coming—not to mention expected here for some three years—it seems to be "front-loaded." That is, the bulk of the bad news is coming at the beginning, rather than at the end. Aware that a recession was nigh, many businessmen cut orders, reduced their inventories, and slashed their payrolls at the first sign of slower sales. Ironically, this could help keep the recession's toll down, since adjustments that normally aren't made until later will help keep downtime to a minimum, and could even lead to an early pickup in new hiring.

Another unusual aspect of this recession is that it seems to be affecting occupations that in the past were barely touched. I'm referring, of course, to such "white-collar" positions as managers, professionals, technical and clerical

support personnel. In particular, lawyers, accountants, media people, commercial and investment bankers, stockbrokers, and real estate people including architects, interior designers and construction personnel have not only lost jobs en masse—they've also had significant difficulty finding new positions in their professions.

Of course, this follows another unusual development—the decline in real estate values in many parts of the country. As explained before, some of this might be a byproduct of the Tax Reform Act of 1986, which suddenly changed the rules for investing in real estate. Thanks in part to the 1981 tax law, real estate had been a sought-after investment, pushing up its value perhaps faster than might otherwise have been the case. Soaring stock prices from 1982-1987 gave real estate a further shove. But except for those who might have purchased a home or other piece of property during the past few years, most are still sitting on real estate worth more than they paid for it. The credit crunch might be making it difficult for some to buy and/or to develop property, but this will change once growth resumes.

Recommendations

There's nothing so odd about this downturn that it can't be rectified by policymakers. The Fed, for one, needs to remember that its primary objective is to ensure a stable financial system in order to foster a sound economy and sustainable economic growth. Inflation will never totally go away in a dynamic, free-market economy such as ours—especially when such external factors as the weather and wars can affect prices of such vital commodities as food and energy. Thus the Fed needs to cut interest rates further by aggressively injecting reserves into the banking system, thereby restoring needed liquidity.

On the fiscal side, Congress ought take another look at the tax laws to see if the changes made back in 1986 in the interests of tax equality have, in the process, served to stifle economic growth by reducing the incentives to invest—especially in real estate. For his part, the President needs to wind up the Middle East war as soon as possible, then turn his attention back to our domestic economy and demonstrate that he can work with the Congress as effectively at home as he has abroad.

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